Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers' Accounting for Postretirement Benefits Other Than Pensions"	)	CC Docket No. 92-101
	)	
Bell Atlantic Tariff F.C.C. No. 1	)	Transmittal No. 497
	)	
U S West Communications Tariff F.C.C. Nos. 1 and 4	)	Transmittal No. 246
	)	
Pacific Bell Tariff F.C.C. 128	)	Transmittal No. 1579
	)	

REPLY TO OPPOSITIONS TO DIRECT CASES

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SUMMARY

Exogenous cost treatment of LEC SFAS-106 costs is appropriate and necessary if the Commission's price cap plan is to function as designed. The Commission's prior orders establish three criteria for exogenous cost treatment of GAAP changes: 1) the changes must have been adopted by the FASB; 2) the changes must be approved by the Commission as consistent with its regulatory accounting needs, and 3) the GAAP change must have a disproportionate impact on the regulated carrier so that the cost changes will not be recovered fully through the inflation component of the price cap formula. Each of these requirements has been clearly established in this case.

The criticisms leveled against the Godwin's study are fully addressed in the USTA reply, which BellSouth adopts and with which it concurs. The Godwin's analysis provides ample evidence that only a small fraction of the LECs' SFAS-106 costs will be recovered through the GNP-PI and other macroeconomic changes. Therefore, the Commission's price cap plan requires that exogenous cost treatment be afforded to the incremental impact of SFAS-106 costs on the LECs.

Some opponents argue that SFAS-106 costs are not "real costs" or that they are "nothing more than an accounting change". These parties clearly do not understand the purpose and effect of SFAS-106. SFAS-106 was mandated to recognize actual, unrecovered costs that employees have

earned but that were not reflected in employer's financial statements under pay-as-you-go accounting. The rates charged to customers by the LECs prior to the adoption of SFAS-106 have reflected only the current cash outlays of these carriers, not the full cost of postretirement benefits earned by their employees. SFAS-106 requires current recognition of these very real costs in the LEC financial statements. Unless exogenous cost treatment of these costs is granted by the Commission, the LECs will be permanently deprived of recovery of costs that were prudently incurred in the provision of service to ratepayers. Such a result would be patently unlawful.

Several opponents fail to recognize the fundamental distinction between exogenous treatment of OPEB expenses, and exogenous treatment of the SFAS-106 accounting change. BellSouth seeks exogenous treatment of only the latter. Some parties analogize SFAS-106 costs to depreciation expense changes, which the Commission has refused to treat as exogenous costs. The more apt analogy is to depreciation reserve deficiency amortization, which the Commission has treated as exogenous costs. Like reserve deficiency amortization, SFAS-106 costs reflect "the result of prior Commission policies". Exogenous treatment of SFAS-106 costs will permit recovery of costs "that would have been included in rates over many past years" if the Commission "had been using [its] current methods all along." Exogenous cost

treatment of SFAS-106 costs is not only compatible with, but is mandated by, the Commission's price cap policies.

The argument of some parties that some of the SFAS-106 costs have been recovered through the authorized rate of return is patently false. This argument is premised on the demonstrably erroneous assumption that investors expected LEC earnings to be depressed as a result of SFAS-106, and that therefore investors reduced LEC stock prices prior to the Commission's rate of return represcription in December, 1990. In fact, as BellSouth demonstrates in this Reply, investors who read the Commission's Orders in the price cap proceeding prior to December, 1990 had every reason to believe that if the Commission approved adoption of SFAS-106, it would grant exogenous cost treatment to the cost increases resulting therefrom. Therefore, informed investors would not assume that these costs would go unrecovered, and would not have bid down the share price of LEC stocks. Arguments based on contrary assumptions are simply false.

BellSouth demonstrates herein that exogenous cost treatment at the levels recommended in the Godwin's study will not result in "double recovery". AT&T's proposal to reduce the medical trend rate by the expected change in the GNP-PI is clearly erroneous. General inflation is present in both the medical trend rate and in the discount rate that form the numerator and denominator, respectively, of the

SFAS-106 accrual. Therefore, general inflation is effectively cancelled out of the SFAS-106 accrual. To remove general inflation again from the medical trend rate, as proposed by AT&T, but not from the discount rate, would grossly understate the appropriate SFAS-106 accrual.

BellSouth demonstrates in this Reply that the criticisms leveled at the actuarial assumptions that underlie the SFAS-106 accrual are without merit. SFAS-106 contains specific requirements that govern the accrual, and the actuarial assumptions made by BellSouth are in full compliance with those requirements. The Commission cannot and should not expect the actuarial assumptions of all of the LECs to be the same. Each LEC is required by SFAS-106 to calculate its accrual based on the experience, demographics and benefit plans of that company. To "benchmark" these assumptions and impose artificial uniformity among the LECs would be directly contrary to the requirements of SFAS-106, and would be patently arbitrary and capricious.

AT&T has presented a series of analyses which it claims demonstrates extreme variation in the LEC OPEB plans. From these analyses, AT&T concludes that an arbitrary limit on the amount of OPEB expenses afforded exogenous treatment should be imposed by the Commission. BellSouth demonstrates herein that the analyses on which AT&T bases its criticism are fundamentally flawed, and are entitled to no weight by

the Commission. There is no evidence in the record that BellSouth's OPEB plans are imprudent, or that any portion of BellSouth's SFAS-106 costs should be disallowed.

The Commission should reject the criticisms aimed at the LEC Direct Cases and approve exogenous cost treatment for SFAS-106 costs.

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REPLY TO OPPOSITIONS TO DIRECT CASES

BellSouth Telecommunications, Inc. ("BellSouth") hereby replies to the Oppositions to its Direct Case filed pursuant to the Commission's Order of Investigation and Suspension, 7 FCC Rcd 2724 (1992).[1] As demonstrated below, the Oppositions are without merit and should be denied.

In its Direct Case, BellSouth relied upon the study performed for USTA by Godwins, Inc. That analysis quantifies the portion of the SFAS-106 costs of the price cap local exchange carriers ("LECs") that may eventually be recovered through changes in the GNP-PI or through other

[1]Oppositions were filed by American Telephone and Telegraph Company ("AT&T"), The Ad Hoc Telecommunications Users Committee ("Ad Hoc"), The International Communications Association ("ICA") and MCI Telecommunications Corporation ("MCI"). Ad Hoc and ICA both attach an identical paper by David J. Roddy and Page Montgomery of Economics and Technology, Inc. ("ETI"). MCI attaches an affidavit by Allan Drazan ("Drazan Affidavit").

macroeconomic effects. USTA has asked Godwins, Inc. to reply to the criticisms of the Godwins' model contained in the Oppositions. BellSouth adopts the Reply of USTA and the analysis by Godwins, Inc. attached thereto.

In the remainder of this pleading, BellSouth will address the following issues: the allegations of Ad Hoc and ETI that the request for exogenous treatment of SFAS-106 costs is inconsistent with price cap regulation; the argument of MCI, Ad Hoc and ETI that SFAS-106 does not involve actual cost outlays that should be borne by ratepayers; the allegation of MCI, Ad Hoc and ETI that the Commission has somehow already granted recovery of SFAS-106 costs through the prescribed rate of return; allegations by all opponents that the LECs are seeking double recovery of some or all of their SFAS-106 costs, and issues relating to the quantification of SFAS-106 costs by the LECs.

I. Exogenous treatment of SFAS-106 costs is both consistent with and required by the Commission's price cap plan.

From the outset of the Commission's consideration of incentive regulation, the Commission has recognized the essential role that the appropriate treatment of exogenous costs plays in its price cap plan.[2] The Commission has

[2] See, In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Further Notice of Proposed Rulemaking, 3 FCC Rcd 3195 at para. 19 (1988); In the Matter of Policy and Rules Concerning Rates for Dominant Carrier, Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd 2873 at para. 38, 253 (1989) ("AT&T Price Cap Order").

stressed that direct recognition of exogenous costs in the price cap index is necessary "to ensure that the price cap formula does not lead to unreasonably high or unreasonably low rates."[3] Exogenous cost adjustments during the first two price cap tariff revisions have resulted in a net reduction in BellSouth's interstate rates of almost $100 million. For the Bell operating companies, the total net downward adjustment due to exogenous changes during this two year period was over $850 million.[4] Clearly, proper recognition of exogenous costs is essential to the proper functioning of price cap regulation.

With specific regard to USOA and GAAP changes, the Commission has held:

> Changes in LEC costs that are caused by changes in Part 32 of our Rules, the Uniform System of Accounts (USOA), will be considered exogenous. We make this classification on the basis that such changes are imposed by this Commission and are outside the control of carriers. However, carriers are not authorized to adjust their price caps automatically to reflect changes in generally accepted accounting principles (GAAP). As explained in the Second Further Notice, certain GAAP changes may require amendment to the USOA while others may not. Carriers must notify us of their intention to apply a change in GAAP and we will allow such change if we find it to be compatible with our regulatory accounting needs. No carrier may adjust its price caps to reflect a change in GAAP until we have approved the carrier's proposed change. Furthermore, we wish

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[3] In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC, Rcd 6786, at para. 166 (1990) ("LEC Price Cap Order").

[4] See, Form EXG-1 of Bell Companies' filed Tariff Review Plans for 1991 and 1992.

> to clarify that no GAAP change can be given exogenous treatment until the Financial Accounting Standards Board has actually approved the change and it has become effective. [Citing AT&T Annual 1990 Price Cap Filing Order, 5 FCC Rcd. 3680 (Com. Car. Bur. 1990)][5]

In the AT&T Price Cap Reconsideration Order, the Commission accepted the argument that there is a possibility of double-counting of a GAAP change between the inflation component of the price cap formula and the exogenous cost adjustment. The Commission adopted a case-by-case review procedure for exogenous cost treatment of GAAP changes.

> As we have recognized in the case of tax law changes, GAAP changes should be eligible for exogenous treatment after a case-by-case review indicates that the changes will not be adequately reflected in the GNP-PI.[6]

The same standard was adopted for the LECs in the LEC Price Cap Reconsideration Order.[7] The Godwins' study was designed specifically to address this issue. It demonstrates clearly that the adoption of SFAS-106 will have a severely "unique or disproportionate" impact on the LECs that will not be fully reflected in the GNP-PI. This is precisely the standard the Commission has set for justifying

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[5]LEC Price Cap Order at para. 168.

[6]In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Memorandum Opinion and Order on Reconsideration, 6 FCC Rcd 665 at para. 75 (1991) ("AT&T Price Cap Reconsideration Order").

[7]In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Order on Reconsideration, 6 FCC Rcd 2637, at para. 63 (1992).

exogenous cost treatment of GAAP changes in the AT&T Price Cap Reconsideration Order.[8]

Both AT&T[9] and Ad Hoc[10] analogize SFAS-106 to depreciation expense and equal access costs which are not afforded exogenous treatment under price cap regulation. A more apt analogy is to the amortization of the depreciation reserve deficiency, which was treated as exogenous by the Commission. The Commission distinguished between depreciation expense, which it treated as endogenous since carriers control the deployment and retirement of assets, and the amortization of a depreciation reserve deficiency, which is "the result of past Commission policies" and is therefore properly treated as exogenous.[11] The Commission stated:

> The need to amortize depreciation reserve deficiencies was created, not by past decisions of this Commission regarding what plant lives should be, but by past methods of calculating depreciation expense. . . . The amortizations currently in effect are part of the transition from the old to the new methods. They represent depreciation expense that would have been included in rates over many past years if we had been using our current methods all along. . . .[12]

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[8] AT&T Price Cap Reconsideration Order at para 74.

[9] AT&T Opposition at 18.

[10] Ad Hoc Opposition at 8.

[11] AT&T Price Cap Order at para. 285.

[12] Id. at para. 292.

Like the reserve deficiency amortizations, the present case involves a change from one method of accounting for the costs of OPEBs to another method. Like reserve deficiency amortizations, the costs for which exogenous treatment are being sought "would have been included in rates over many past years if we had been using our current methods all along." And unlike depreciation expense, which the Commission held would be fully recovered under its current methods over the life of the plant without exogenous treatment, failure to afford exogenous treatment to SFAS-106 costs will permanently deprive the carriers of recovery of prudently incurred costs. Therefore, appropriate application of Commission precedent requires exogenous cost treatment of SFAS-106 costs.

Ad Hoc asserts that in order to justify exogenous treatment of SFAS-106 costs the LECs must prove confiscation[13]. This is patently false and constitutes a serious misrepresentation of the Commission's prior holdings. The Commission's discussion of a showing of confiscation as a predicate to exogenous treatment did not apply to exogenous cost categories such as USOA and GAAP changes that were discussed explicitly in the LEC Price Cap

[13]Ad Hoc asserts: "Finally, as a logical outgrowth of these policy-oriented concerns, the Commission has held that where price cap policy objectives are implicated, a carrier must demonstrate that, without the adjustment that exogenous cost treatment would allow, a carrier's rates under price cap regulation would be confiscatory." Ad Hoc Opposition at 10-11.

Order. Rather, that discussion related to a suggestion by some commenters that the Commission adopt a separate exogenous cost category for "uncontrollable 'extraordinary' costs that result from natural disasters or for cost changes mandated by this Commission."[14] The Commission rejected this request to create "an automatic flow-through of all extraordinary costs."[15] The Commission then went on to state that,

> [C]onsistent with the Constitutional ban on confiscatory rates, we leave open the possibility that, in a truly extraordinary situation, we would approve above-cap rates, even perhaps without suspension and investigation.[16]

The Southwestern Bell case cited by Ad Hoc is clearly not on point with the present case. There Southwestern Bell sought to justify above-cap rates going into price caps based on its earnings during the period immediately preceding price cap regulation. The Commission held that Southwestern Bell had not met the standard applicable to "extraordinary exogenous costs".[17] Nowhere in the Southwestern Bell case does the Commission even hint that this is the standard applicable to analyze those exogenous

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[14] LEC Price Cap Order at para. 189.

[15] Id.

[16] Id. at para. 190.

[17] In the Matter of Southwestern Bell Telephone Company, 7 FCC Rcd. 2906, 2911 (1992).

cost categories, such as GAAP changes, that were explicitly addressed in the LEC Price Cap Order.

The appropriate standard for reviewing exogenous cost treatment of GAAP changes is a straightforward three part analysis: (1) Has the change become effective? (2) Has the Commission authorized the carrier to adopt the change? (3) Does the change have a "unique or disproportionate" impact on the carrier vis-a-vis the economy generally? Once these three questions have been answered in the affirmative, as they have been in this case, the issue is simply one of quantification, which is hardly unique to the evaluation of exogenous cost changes. Issues regarding quantification of the SFAS-106 accrual are discussed in Section V, below.

II. SFAS-106 reflects actual, unrecovered costs that BellSouth is legally entitled to recover from ratepayers.

ETI asserts that SFAS-106 represents a balance sheet adjustment, not a real cost.[18] It asserts that "because there is no increase in actual cost to the LECs, there is nothing to be passed on to the ratepayer."[19] MCI also characterizes SFAS-106 as "nothing more than an accounting change . . . ."[20] These assertions are misleading and miss the point.

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[18]ETI at 2.

[19]Id. at 12.

[20]MCI Opposition at 8.

Postretirement benefits are real costs. The purpose of SFAS-106 accrual accounting is to recognize these costs at the time these benefits are earned by employees. The effect of cash accounting for these costs is to understate these costs currently.

The FCC recognized the appropriateness of GAAP accounting in restructuring the USOA. In recommending the adoption of GAAP accounting for regulatory purposes, the TIAG made the following comments:[21]

> The most conceptually sound economic measurements of financial condition are believed to be GAAP as embodied in the statements of the FASB and its predecessors, since such principles are recognized, accepted and consistently applied in the business and financial community for analytical and decision-making purposes. Thus, the use of GAAP in the telephone industry will provide better and more reliable information for the pricing of services and for other uses by regulators, management, investors and creditors, as well as for the protection of all users and ratepayers from improper and inconsistent accounting methods.[22]

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[21]The FCC charged the telecommunications Industry Advisory Group (TIAG) with developing and recommending a revised USOA based generally on financial principles. Among other things, the TIAG was to develop a recommendation on the extent to which GAAP should be used in a revised USOA. On November 16, 1983, the TIAG filed with the Commission its report entitled "Discussion Paper on Application of Generally Accepted Accounting Principles in a Revised Uniform System of Accounts" ("Discussion Paper") with which the Commission was in general agreement. In the Matter of Revision of the Uniform System of Accounts for Telephone Companies to Accommodate Generally Accepted Accounting Principles, CC Docket No. 84-469, Report and Order, FCC 85-581, released November 14, 1985 at paras. 3-6, 20.

[22]Discussion Paper at 7.

With respect to using GAAP for ratemaking purposes, the TIAG report further states:

> Finally, the accounting and ratemaking directives which have in the past and currently do affect the application of GAAP by regulated telephone companies were developed in a regulated monopoly environment which existed prior to the introduction of competition. . . . Thus, the prior regulatory accounting and ratemaking practices which deferred cost recovery are inappropriate for the current environment because the effect of such accounting practices places telephone companies at a competitive disadvantage in the capital markets. . . . To compete effectively, regulated telephone companies need . . . to reflect in the prices of services the costs of doing business as determined by such generally accepted accounting practices.[23]

The initial LEC price cap rates reflected cash accounting rather than accrual accounting for OPEBs. Therefore, the LECs' initial price cap rates understated the actual economic costs being incurred. Exogenous treatment of the change from cash to accrual accounting mandated by SFAS-106 will merely correct this prior deficiency and reflect current economic costs in current rates.

Both AT&T and MCI suggest that the Commission impose restrictions on the use of the cash generated through exogenous cost treatment of the change in accounting for OPEBs.[24] AT&T's suggestion stems from their concern that the LECs could recover SFAS 106 accrual costs and in the future reduce actual benefits paid. It suggests that the

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[23] Discussion Paper at 9.

[24] AT&T Opposition at 14-16; MCI Opposition at 11, fn. 14.

Commission limit the exogenous cost adjustment to the amount that is prefunded. MCI's suggestion stems from their concern that LECs would enjoy the use of ratepayer funds used to cover these accruals for several decades. Both arguments are without merit.

In response to AT&T's allegations, it should be noted that BellSouth is seeking Commission approval to treat, as a one time exogenous event,[25] the increase in costs resulting from the change from cash accounting to accrual accounting mandated by SFAS 106. Once the exogenous adjustment is made, BellSouth proposes to treat OPEB costs like any other cost of doing business. Therefore, future changes in BellSouth's benefit plans are irrelevant to the issue of exogenous treatment. BellSouth would absorb future increases as well as future decreases in the OPEB expense levels just like any other expense changes that will impact the company.[26]

In response to MCI's allegations, the Commission already has in place rules dealing with the funding issue. To the extent that a LEC fails to fund, the unfunded amount

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[25]The fact that BellSouth plans to treat this as a one time exogenous event also addresses AD HOC's implication that the LECs would benefit from "gold-plating" their benefits. Ad Hoc Opposition, at 16.

[26]Future levels of OPEB expenses are just as likely to increase as they are to decrease. Market conditions might require the recognition of losses in future periods and plan amendments increasing benefits will require the recognition of prior service costs in future periods.

will be accounted for in account 4310, which is a deduction from the rate base. There is, therefore, no need to place additional restrictions on the use of the funds.

AT&T and MCI invite the Commission to adopt elaborate tracking and reporting mechanisms for the funds generated by the exogenous cost adjustment. Each of these suggestions would involve the Commission in micromanagement of carrier cash flows with no discernable benefit to ratepayers. Such mechanisms are neither necessary nor desirable, and should be rejected.

III. SFAS-106 costs are not recovered through the authorized rate of return.

MCI[27], Ad Hoc[28] and ETI[29] assert that some SFAS-106 costs are recovered through the Commission's prescribed authorized rate of return. These arguments are specious and must be rejected.

MCI hypothesizes that LEC stock prices in 1990 reflected an expectation that SFAS-106 costs would depress earnings following adoption.[30] The DCF model, according to

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[27]MCI Opposition at 11-17; Drazen Affidavit at 1-4.

[28]Ad Hoc Opposition at 17, fn. 45.

[29]ETI at 11-12.

[30]MCI correctly notes that the stocks of the Bell Holding Companies are among the most widely held stocks in the country, and that factors affecting the earnings of these companies are carefully scrutinized by analysts, mutual funds and trustees. MCI Opposition at 14. The Commission's price cap proposal for the LECs was widely researched, and the Commission may comfortably assume that (continued...)

MCI, captured that expectation in the dividend yield component of the model, thereby compensating investors for the anticipated reduction in future earnings.[31] MCI explicitly recognizes that its hypothesis is totally dependent upon an assumption that investors believed that the LECs would not be allowed by regulators to recover SFAS-106 costs:

> An argument could be raised that investors would assume that the LECs would be granted regulatory relief for SFAS-106 costs, and therefore their stock prices would remain unaffected. This, however, would be a faulty analysis unless it was provided by LECs to their investors; regulators never indicated that these expenses were allowable.[32]

Contrary to MCI's unsupported assumption, investors had every reason to believe that this Commission would permit recovery of SFAS-106 costs as an exogenous cost adjustment. The Commission's orders prior to the rate of return represcription in December, 1990 could lead an informed investor to no other conclusion.

In the AT&T Price Cap Order, released April 17, 1989, the Commission stated:

> We confirm our tentative conclusion that cost changes due to changes in the Uniform System of Accounts should be treated as exogenous cost factors. We also agree that there is no

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[30](...continued)
the contents of its orders with regard to the LEC price cap plan was widely disseminated in the financial community.

[31]MCI Opposition at 15.

[32]MCI Opposition at 16.

> difference in principle between a cost change caused by a USOA change and a cost change caused by a GAAP change. We do not, however, authorize carriers automatically to adjust price caps to reflect changes in GAAP. Our current procedures for implementing GAAP in the context of the USOA require carriers to notify us of their intention to apply a change in GAAP. They may make the change only if we find it to be compatible with regulatory accounting needs. Some changes in GAAP which are compatible with regulatory needs can be carried out within our existing rules, while others may require amendment of the USOA. A carrier may not adjust its price caps to reflect a change in GAAP until we have approved that change.[33]

The Commission sent a clear signal to investors in 1989 that any GAAP changes the Commission found compatible with its regulatory accounting needs would qualify for exogenous cost treatment under price caps. Footnote 605 in the AT&T Price Cap Order made that intent abundantly clear:

> Changes in generally accepted accounting principles are adopted by the Financial Accounting Standards Board (FASB). One could say that GAAP changes affect all entities in the economy and thus are already reflected in the GNP-PI. However, following this line of reasoning would require us by the same logic to prohibit exogenous cost changes for USOA changes that implement GAAP. Furthermore, it is not always clear that GAAP changes, implemented within a regulated system of accounts, have the same impact on carriers as the same changes implemented by industries which do not follow regulated accounting practices. Therefore we conclude that all accounting changes imposed by outside regulatory authority can give rise to exogenous cost adjustments.

In the LEC Price Cap Order, which was released on October 4, 1990, the Commission reaffirmed that the full impact of GAAP changes would be considered as exogenous cost

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[33] AT&T Price Cap Order at para. 295.

changes, provided that the FASB action adopting the change was final and further provided that the Commission approved the change as consistent with its regulatory accounting needs.[34] Thus, at the time of the rate of return represcription cited by MCI, investors had every reasons to expect that LEC earnings would not be depressed by SFAS-106 costs.

MCI's reliance on the Drazen Affidavit is misplaced First, Professor Drazen explicitly asserts that "the stock price of a company whose earnings are expected to be strongly affected will fall relative to those companies whose costs will be less affected."[35] (Emphasis added.) As applied to the LECs, this assertion is contrary to the Commission's pronouncements during the time frame relevant to the December, 1990 rate of return represcription. As shown above, the Commission's pronouncements prior to the rate of return represcription would lead a prudent investor to assume that SFAS-106 costs would be treated as exogenous. Therefore, there was no reason to assume that LEC earnings would be adversely affected as a result of the adoption of SFAS-106.

Second, Professor Drazen's conclusions are based on papers by Mark Warshawsky of the Federal Reserve Board. Far

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[34]See, quote from the LEC Price Cap Order set forth in this text at page 3.

[35]Drazen Affidavit at para. 5.

from contradicting the Godwins' analysis, Warshawsky confirms essential elements of that analysis. For example, as Professor Drazen concedes in his Affidavit, Warshawsky confirms the essential finding of Godwins that companies like the LECs that have extensive post-retirement benefit plans will be disproportionately impacted by SFAS-106.[36] Warshawsky expressly recognizes that the impact of SFAS-106 on regulated firms depends on the degree to which regulators permit such firms to recover these costs through price increases.[37] Moreover, the sample employed by Warshawsky did not include telecommunications service providers like the LECs.[38] Therefore any attempt by Professor Drazen to extrapolate the results of Warshawsky's analysis to the LECs is purely speculative and unsubstantiated.

Professor Drazen's speculation that SFAS-106 costs may be ameliorated in the future by corporate or government action is unsubstantiated. Unlike Professor Drazen[39], BellSouth's actuarial assumptions do not speculate regarding the possible advent of national health insurance. However, BellSouth's actuarial assumptions do project a substantial

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[36]Drazen Affidavit at para. 7.

[37]Mittelstaedt and Warshawsky, "The Impact of Liabilities for Retiree Health Benefits on Share Prices" Finance and Economics Discussion Series Paper 156, Federal Reserve Board (April, 1991) at 1.

[38]Id. at 14 and Table III at 30.

[39]Drazen Affidavit at para. 10.

decrease in the medical trend rate. Thus, even if national health insurance were to become a reality, BellSouth's current medical trend rate assumption would mitigate the effect of such an event.[40]

IV. BellSouth does not seek to "double recover" any of its OPEB costs.

In addition to the alleged double recovery through the prescribed rate or return refuted above, all of the Oppositions assert that the Direct Cases of the LECs would result in "double recovery" of some or all of the carrier's OPEB costs. These assertions are without merit.

AT&T asserts that the LECs "double count" inflation in the proposed exogenous cost adjustments. AT&T asserts that inflation is recognized in the GNP-PI and again in the medical trend rate that is part of the SFAS-106 accrual calculation.[41] AT&T proposes to eliminate this alleged "double count" by subtracting the expected rate of inflation from the medical trend rate used in calculating the accrual.[42] MCI makes a similar proposal.[43] Both of these proposals are unnecessary and unwarranted.

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[40]BellSouth recognizes the uncertainty that could occur in the event of a major change in circumstances, such as the advent of national health insurance. BellSouth would not object to a reexamination of the exogenous cost adjustment permitted by the Commission should such an event occur.

[41]AT&T Opposition at 5-14.

[42]Id. at 13-14.

[43]MCI Opposition at 31.

Both MCI and AT&T fail to recognize that although long-term inflation is included in the medical trend rate, anticipated inflation is also embedded in the discount rate. Discounting the expected benefit stream to present value using a long-term nominal rate that includes anticipated inflation effectively removes inflation from the calculated accrual.[44] AT&T's method of removing the expected long term rate of inflation from the medical trend without also removing it from the discount rate would grossly understate the appropriate SFAS-106 accrual.

V. The criticism of the actuarial assumptions and quantification of the SFAS-106 accrual are without merit.

All of the oppositions take pot shots at the quantification of the SFAS-106 accrual of each LEC and the actuarial assumptions that underlie those accruals. AT&T proposes to "benchmark" several critical components of the accruals in an attempt to standardize the assumptions underlying the SFAS-106 accruals for purposes of calculating the exogenous cost adjustment.[45] Neither the criticisms of the actuarial assumptions underlying the SFAS-106 accrual, nor AT&T's proposal to "benchmark" those assumptions are valid.

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[44]BellSouth demonstrates this algebraically on Exhibit 1, attached hereto.

[45]AT&T Opposition at 25-29.